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RUEHSG/AMEMBASSY SANTIAGO 6073
RUEHBU/AMEMBASSY BUENOS AIRES 4561
RUEHAC/AMEMBASSY ASUNCION 5919
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RUEHQT/AMEMBASSY QUITO 2119
RUEHPE/AMEMBASSY LIMA 3344
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C O N F I D E N T I A L SECTION 01 OF 04 BRASILIA 000149

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TAGS: ECON EFIN PGOV ETRD PREL EINV BR
SUBJECT: BRAZIL: LULA'S SECOND TERM ECONOMIC GROWTH PACKAGE
UNDERWHELMING

REF: A) 06 BRASILIA 2490
B) BRASILIA 0060
C) BRASILIA 0140

Classified by Economic Counselor Bruce Williamson, reasons 1.4 (b) and (d).

¶1. (SBU) Summary: The GoB announced on January 22 a series of measures, the Program to Accelerate Growth (PAC), meant to enliven Brazil's current lackadaisical economic growth rates. The measures, a combination of targeted tax breaks and new public spending, along with the recycling of a few existing initiatives, primarily are aimed at boosting investments in infrastructure and construction. A few additional pieces of legislation would streamline bureaucracy, particularly in the area of environmental permits for large projects, and improve the investment climate. The GoB has spun the PAC as potentially pumping Reais 500 billion (USD 235 billion) into the economy over the next four years, but the figures are notional and depend to a great extent on the implementation of over 21 individual initiatives requiring congressional approval, as well as investment decisions by private actors. Overall, the package reflects the Lula Administration's preference for use of the state -- as opposed to the private sector -- as the engine for increased economic growth. Analysts have welcomed the steps as useful, but note they are only a modest attempt at addressing the fundamental structural distortions that dampen the potential growth of the Brazilian economy (refs A and B). The two most urgent issues, tax/fiscal reform and reform of the social security system, were not addressed by the PAC, although President Lula stated that these issues as well would be dealt with separately (in an unspecified time frame). Ref C reviews the PAC's political prospects and impact. End Summary.

¶2. (SBU) The GoB announced on January 22 its long-awaited economic package for Lula's second term. The unveiling was

delayed for close to a month after Lula's dissatisfaction with the lack of "daring" in the Finance Ministry's initial proposals. The bureaucratic infighting over the package led to resignation of the Finance Ministry Treasury Secretary, Carlos Kawall, whose more fiscally conservative stance Lula ultimately overruled, notably in increasing the minimum wage to Reais 380 (USD 180) per month. In the end, the GoB put forward a group of twenty-one pieces of legislation -- five of which already had been submitted to Congress in years past and have yet to be approved -- with the primary purpose of increasing investment in infrastructure and construction. The five bills already under Congressional consideration, most of which were aimed at improving the investment environment, are: 1) the regulatory agencies law; 2) a law to regulate the natural gas market; 3) a law to strengthen the competition policy framework; 4) legislation to improve social security management and reduce fraud; and, 5) a bill to unify the social security and federal government tax collections systems ("super-receita"). Seven provisional measures (MPs) were issued to enact a series of targeted tax breaks. (Note: MPs are presidential decrees that take immediate effect but must nevertheless receive congressional ratification within a certain period of time to become permanent law.) A further three MPs dealt with the minimum wage increase and created rules to try to limit the growth of the government's wage bill and create a more predictable system for granting future minimum wage increases.

Targeted Tax Breaks, New Spending

¶3. (U) The PAC contained seven MPs that implemented a series of tax breaks and spending measures to try to boost infrastructure

investment, both private and public, and boost the construction industry. One MP shortens, from 25 years to 24 months, the period over which new construction projects can claim already existing PIS and COFINS tax credits, injecting an estimated Reais 1.15 billion (USD 540 million) into the construction sector. Another MP exempts from federal income tax investment earnings from new private sector infrastructure investment funds. A related measure creates PIS and COFINS tax exemptions on the sales of materials and services used in new infrastructure projects such as ports, sanitation, and power generation and distribution. A law to create a more streamlined and coordinated system of granting environmental licenses for major infrastructure projects, thus addressing a major business complaint, complements the infrastructure-related tax breaks.

¶4. (U) New spending on construction and infrastructure also is on tap under the PAC. One MP calls for a Reais 5.2 billion hybrid loan/capitalization instrument from the GoB to the para-statal bank Caixa Economic Federal (CEF). The loan draws on GoB assets on deposit at the Central Bank, and thus does not impact the primary fiscal surplus. The CEF will on-lend the money for low income housing and sanitation projects. Another MP, aimed at increasing resources for low-income housing projects, will allow the PAR, a national program which built and leased low-income housing, to sell the homes to their occupants should they desire. This would create additional liquidity for the PAR fund and allow additional low income housing construction.

¶5. (U) The most controversial measure in the PAC is the creation of a new governmental infrastructure investment fund financed from the profits and "net capital" of the unemployment insurance fund (FGTS). The FGTS, which is funded by payroll taxes, by law is the primary source of funding for the Economic and Social Development Bank (BNDES). BNDES profits are returned to the fund and build up its capitalization. Labor groups already have challenged the constitutionality of the PAC's plan to use Reais 5 billion (USD 2.4 billion) from FGTS to finance the new government infrastructure fund (ref C).

Fiscal Unease

¶6. (SBU) CSFB economist Nilto Calixto pointed out to Emboff in January 25 conversation that the PAC made it clear that the GoB would reduce its primary surplus in the future. This could theoretically begin to happen in 2007, as the GoB more than doubled the size of the Pilot Investment Project (PPI) (from Reais 4.3 billion to Reais 11.3 billion -- about USD 5.4 billion, or 0.5% of GDP). Under the GoB's budget rules, federal investments through the PPI (which require a vetting process to ensure they have positive economic returns) are not counted against the primary surplus target, so full implementation of the PPI would imply a reduction in the primary surplus target from 4.25% of GDP to 3.75% of GDP. Calixto cautioned, however, that the GoB's dismal record of budget execution -- including under the PPI in 2005 and 2006 -- meant that it was unrealistic to expect that the PPI would be fully executed.

¶7. (SBU) The CSFB economist predicted the GoB would actually run a primary surplus of close to 4.25% of GDP in 2007, as the machinery of public spending would take some time to adjust. To illustrate the point, Calixto noted that the GoB posted a primary surplus of about 4.4% of GDP in 2006, despite a concerted effort to increase public investments in the run up to the elections. The only category of spending where the GoB had over-performed was on salaries and benefits, as the GoB increased the minimum wage substantially and gave civil servants

significant wage increases. After 2007, however, Calixto expected the primary surplus would begin to fall below the current 4.25% of GDP target.

¶8. (SBU) Calixto noted that, given falling interest rates, which have significantly reduced the GoB interest bill, there is room for the GoB to continue reducing the debt-to-GDP ratio even as it runs smaller primary surpluses. By his calculation, the GoB need only run a primary surplus of 2% of GDP in 2007 to keep the debt-to-GDP ratio roughly stable at the current 50% of GDP. Looser fiscal policy, therefore, need not signal fiscal irresponsibility. The fundamental question is how quickly Brazil reduces its stock of debt and borrowing requirement, which still soaks up significant amounts of private capital, in order to increase the space for private investment. Through the PAC, the GoB is signaling it intends to use the fiscal space to finance higher public spending, not facilitate greater private investment. Calixto's study, however, had concluded that the benefits of a quicker reduction in debt, which would open the doors to greater (and more efficient) private investment, exceeded the benefits of higher public spending, even were the public spending directed entirely to infrastructure investment.

¶9. (SBU) While key items to extent both constitutional budget de-earmarking provisions and a financial transactions tax (CPMF) were not included in the PAC -- but likely will be contained in separate legislation -- it does incorporate a few measures meant to assuage doubts about the GoB's commitment to fiscal responsibility raised by other parts of the plan. In order to contain the growth of public spending on salaries and benefits, including social security benefits, which constitutionally are linked to the minimum wage, the PAC creates rules for future adjustments in public sector salaries and the minimum wage. One MP links annual salary increases to inflation plus a real adjustment of 1.5% per year. If implemented, this would likely reduce the proportion of public spending going to salaries. A second MP links future minimum wage increases to inflation in the previous year plus the rate of real GDP growth in the year before that (i.e. t-2). CSFB's Calixto and prominent fiscal expert Raul Velloso both questioned the effectiveness of the spending rules, however, arguing that over time such rules tend to become floors for future increases, instead of ceilings. Another bill, already in Congress, would tighten management of the social security system and try to reduce fraud. A final measure, not yet submitted to Congress, would implement a constitutional amendment passed in 2003 to reduce the generosity of the public sector employees' pension benefits.

Topping up the "MP do Bem" benefits for Electronics
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¶10. (U) Two MPs will create additional tax breaks meant to stimulate research and development for digital television products by granting tax exemptions (PIS, IPI, COFINS and CIDE) on the sales of digital transmission equipment and investment in capital goods and transfers of technology for the development of this equipment under a program called PATVD. A program labeled PADIS will create similar tax incentives for semiconductor investments.

Former Presidential Candidate Alckmin: Not Far Enough
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¶11. (SBU) Echoing comments that Sao Paulo state Governor Serra made to the press January 25, Geraldo Alckmin, unsuccessful candidate of the Brazilian Social Democracy Party (PSDB) for president last year, told CG Sao Paulo Poloff on January 23 that the PAC is a positive measure and it will help stimulate growth,

but it doesn't go far enough. It will not reduce the tax burden, which is the major factor driving the informal economy, he said. There are simply too many obstacles to economic growth, such as high interest rates, Alckmin said. He explained that if the government reduces the primary surplus, as it will have to increase spending to stimulate growth, this will make the task of lowering interest rates both harder and longer. For the past few years, structural reform, which is needed to attract investment and stimulate growth, has been stopped, he said. (Note: Alckmin gave us the familiar litany of needed reforms: political reform, tax reform, social security reform and labor reform, all of which he had proposed to do if elected president. End note.) The PAC will bring growth to some sectors of the economy, but won't affect the macro elements: budget, interest rates, and the exchange rate. He opined that when Lula came into office, the Workers Party (PT), provided good continuity in macroeconomic policy but got the dosage wrong: the high interest rates were appropriate to the FHC era because he faced so many international economic crises and slow world growth, but the past few years have been a good period for the international economy, and Lula didn't make the appropriate adjustments to reflect that, Alckmin concluded.

¶12. (C) Comment: A more "daring" economic program, to borrow Lula's term, would have addressed the central economic distortions in the Brazilian economy, the solutions to which begin with reforming the soon-to-be bankrupt social security system, the burdensome tax system and the rigid fiscal framework. While there are measures of incremental merit in the PAC, the program that Lula meant to be the economic foundation of his second term in office seems to be mostly beside the point.

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